Exhibit A

BlueCross BlueShield of Vermont

An Independent Licensee of the Blue Cross and Blue Shield Association.

January 21, 2010

Peter F. Young, Esq.
Assistant General Counsel
Vermont Department of Banking, Insurance, Securities
And Health Care Administration
89 Main Street, Drawer 20
Montpelier, VT 05620-3101

RE: Order to Show Cause, Dkt. No. 09-131-H

Dear Peter:

As follow-up to Tuesday's telephone conversation, I am providing you with the enclosed copy of the report prepared by Peter Zamore, of Sheehey Furlong & Behm PC, concerning the issues raised in paragraph C of the above-referenced Order to Show Cause. The enclosed copy of the report is provided for you to preview, prior to our formal filing.

I would also like to take this opportunity to review the steps BCBSVT has already taken with respect to (i) attempts to recover amounts paid to Bill Milnes pursuant to his Supplemental Executive Retirement Plan (SERP), and (ii) limitations on current and future executive compensation payments. Regarding attempts to obtain voluntary recovery, Don George contacted Mr. Milnes in early July 2009 to request an in-person meeting among Messrs. George and Milnes, as well Board Chair Guy Boyer and Director Frank Duzy, to discuss issues pertaining to Mr. Milnes' retirement compensation. Mr. Milnes declined the invitation and asked that all future correspondence be directed to his attorney, Tony Ciriaco. On July 17, I spoke with Mr. Ciriaco and requested that he pass along BCBSVT's request that Mr. Milnes return a portion of the SERP payment. On July 28th, I received a letter from Mr. Ciriaco declining our request. Since then, I have had several additional phone calls with Mr. Ciriaco during which he has made it quite clear that Mr. Milnes is not willing to make a voluntary repayment of any portion of the SERP distribution.

The recent experience with Mr. Milnes' retirement payments, as well as changing attitudes toward executive compensation in the current external economic environment, caused our Board of Directors and our Executive and Compensation Committee (the "Committee") to take a closer look at BCBSVT's executive compensation policies and practices. During 2009, the Committee met eight times to discuss issues specifically pertaining to executive compensation. At the outset of this process, the committee engaged an independent consultant, Warren Kerper of SullivanCotter & Associates' Boston office to assist it with its analysis of executive compensation issues. Actions arising from this series of meetings included the following:

- the Committee adopted a Total Compensation Philosophy statement that includes clarification of governance roles, including
  - clarification that the Committee is responsible for establishing the total compensation strategy for BCBSVT employees;

  - acknowledgement that compensation levels must recognize the unique characteristics of the Vermont market;
  - a requirement that the Committee conduct an annual review of executive total compensation; and
  - a requirement that the Committee ensure transparency and disclosure to the Board on executive compensation decisions.
- Don George's participation in the executive SERP was frozen as of March 2, 2009, the date on which he was elected President and CEO.
- Re-benchmarked every executive position through peer comparisons, including reference to the Vermont market and confirmed appropriate compensation levels for each executive.
- Terminated BCBSVT's executive Long-Term Incentive Program.
- 2010 annual incentive program targets have been set at "industry leading" performance; stretch goals set at "best in class" performance.

In addition to these actions taken at the Board/Committee level, management realigned the responsibilities of BCBSVT's executives and, in the process, reduced the number of Vice Presidents from eight to six. As a result, aggregate executive compensation paid in 2009 was approximately $1 million less than the amount paid in 2008 (disregarding the SERP payment to Mr. Milnes in 2008). In addition, management voluntarily agreed not to provide merit increases to executives in 2009. (This decision was subsequently extended to include to all employees.)

We believe that the Board and the Committee have given thoughtful consideration to the development of a total compensation strategy which recognizes and balances the need to attract and retain qualified executives, the economic realities of BCBSVT and the business and regulatory environment in which it operates and the unique characteristics of Vermont. The changes described above clearly reflect meaningful change in BCBSVT's approach to executive compensation.

Over the past several months, we have devoted substantial internal and external resources toward the resolution of the issues pertaining to Mr. Milnes' retirement payments. All the work we have performed tends to indicate that there is no realistic opportunity to recover any portion of the SERP payment from Mr. Milnes and any action to recover a portion of that payment would likely be fruitless. Meanwhile, we have adopted new policies and practices that add rigor and transparency to the executive compensation decision-making process, thereby providing strong assurance against the payment of compensation at levels that would be inconsistent with the Total Compensation Philosophy. At this point, we would encourage the Department to focus on the significant work of our Board, the Committee and management as it works toward a resolution of paragraph C of the Order to Show Cause.

If you have comments or questions about the above, please don't hesitate to contact me.

Very truly yours,

Christopher R. Gannon
Vice President and Chief Administrative Officer

cc: Peter H. Zamore, Esq.
Mr. Kevin Goddard

REPORT OF BLUE CROSS AND BLUE SHIELD OF VERMONT
TO
THE DEPARTMENT OF BANKING, INSURANCE, SECURITIES AND HEALTH CARE ADMINSTRATION
CONCERNING
THE MILNES SERP PAYMENT
January 20, 2010

I. INTRODUCTION

This Report contains an analysis of whether Blue Cross and Blue Shield of Vermont ("Blue Cross") can be required to recover a payment to William R. Milnes, Jr. ("Milnes") under the 2006 Supplemental Executive Retirement Plan ("SERP"), in connection with a recent Order from the Vermont Department of Banking, Insurance, Securities and Health Care Administration ("BISHCA") requiring Blue Cross to show cause whether

> the Company be ordered to file an approved plan to recover that portion of the post-employment compensation of the Company's former Chief Executive Officer deemed by the Commissioner to be excessive under the insurance laws of this state, under the health insurance laws specifically applicable to the Company, and under Vermont's non-profit corporation laws

In re Blue Cross Blue Shield of Vermont, Docket No. 09-131-H (November 3, 2009) ("BISHCA Order") at 6. In particular, the Report analyzes (1) whether BISHCA has authority to require Blue Cross to seek or obtain recovery of the SERP payment and (2) whether attempted recovery would be successful on the basis identified in the Order.[1]

Based on this analysis, although BISHCA may have authority to require Blue Cross to seek recovery of the Milnes SERP payment,[2] it does not have authority to require recovery of the payment and any such BISHCA-imposed recovery requirement would likely constitute an unconstitutional impairment of contract. It also appears that Blue Cross is not entitled to recover the SERP payment because the SERP is an enforceable contract, and even if there were a basis for invalidation of the SERP, any recovery would likely be limited to the amount in excess of the value of Milnes' SERP-related services.

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[1] In analyzing whether the SERP payment can be recovered as excessive under the insurance and non-profit corporation laws, the following statutes were reviewed: 8 V.S.A. Chapters 1 (general authority), 101 (insurers generally), 107 (health insurers), and 123-25 (hospital and medical service plans) and 11B V.S.A. (nonprofit corporations).

[2] As indicated below, Milnes has rejected Blue Cross' request for voluntary return of a part of the SERP payment.

This Report is based on a review of the following documents provided to us by Blue Cross: Blue Cross Articles of Association (as of February 8, 2005), the Bylaws (as of March 26, 2008), minutes of certain Board of Directors ("Board") meetings between March 28, 2001 and November 26, 2008, minutes of certain Executive and Compensation Committee ("Committee") meetings between December 18, 2002 and March 4, 2009, certain documentation relating to Milnes' employment by Blue Cross (including his employment agreement and the SERP), Summary Plan Description of the Blue Cross qualified retirement plan, Report of the December 31, 2005 Statutory Examination of Blue Cross by BISHCA, excerpts of the 2006-2008 annual financial reports to BISHCA, various executive compensation analyses undertaken by Mercer Consulting ("Mercer"), excerpts of a September 14, 2007 report of Deloitte Consulting LLP ("Deloitte Report") and an associated summary presentation dated July 17, 2007 and updated August 21, 2007 ("Deloitte Presentation"), the November 19, 2008 letter agreement between Blue Cross and Milnes concerning retirement arrangements, a BISHCA Order in Docket No. 09-131-H dated November 3, 2009 and other related documentary information.

II. FACTS

Blue Cross is a nonprofit corporation[3] established under 8 V.S.A. Chapter 123 to maintain and operate a hospital plan under Chapter 123 and a medical service plan under Chapter 125. It is required to be "maintained and operated solely for the benefit of subscribers," and may provide services "that are intended to insure that subscriber benefits are provided at a minimum cost under efficient and economical management." 8 V.S.A. § 4512(a),(c). Except to the extent provided in Chapters 123-125, Blue Cross is subject to the provisions of Vermont's Nonprofit Corporation Act, 11B V.S.A. It is subject to regulation by BISHCA with respect to, among other things, rates, terms, and conditions relating to contracts with subscribers. 8 V.S.A. §§ 4512-15, 4584-87.[4]

Milnes began employment with Blue Cross as President and Chief Executive Officer ("CEO") on March 26, 1998. Initial compensation included a base salary of $260,000, which could be increased but not decreased, and an incentive payment of up to one-third of base salary,

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[3] Blue Cross is not subject to Section 501(c)(3) of the Internal Revenue Code or required upon dissolution to distribute its assets to a governmental entity or a Section 501(c)(3) corporation. Articles of Association. It is therefore a mutual benefit corporation, rather than a public benefit corporation. 11B V.S.A. § 17.05.

[4] In addition, BISHCA approval is required with respect to, among other things, investment guidelines, mergers, consolidations, and sales of ten percent of assets, subscribers or ownership interest. 8 V.S.A. §§4512, 4517, 4523.

75% of which was to be paid after the end of the calendar year and the remainder three years thereafter. Employment Agreement dated as of March 26, 2008 ("1998 Employment Agreement") at 1-2. Benefits required to be paid under the 1998 Employment Agreement included a Supplemental Executive Retirement Plan dated as of January 1, 1999 ("1998 SERP"). 1998 Employment Agreement at 3-4. Benefits under the 1998 SERP were accrued and vested as earned, were payable upon retirement, disability or any other termination of employment (voluntary or involuntary), and "shall not be eliminated or diminished by the Employee's subsequent termination of employment for whatever reason; provided, however, that no further benefits shall accrue following termination." 1998 Employment Agreement at 4. The 1998 SERP provided that Milnes was entitled to a supplemental retirement benefit over his lifetime equal to (1) 60% of the highest five years' average base and bonus compensation paid, payable or deferred during the last ten full years of employment less (2) the sum of qualified plan retirement benefits and amounts payable under a split-dollar insurance policy on the life of Milnes' spouse. 1998 SERP at 2-4; Equity Split-Dollar Rollout Insurance Agreement at 1. Milnes could elect any form of payment of 1998 SERP benefits that was available under the Blue Cross qualified retirement plan.

In 2005, Blue Cross established an Ad Hoc Committee of the Board, to review various benefits, including supplemental executive retirement benefits. The Ad Hoc Committee recommended changes to the 1998 SERP to comply with the requirements of Section 409A of the Internal Revenue Code. The Executive Committee approved the recommendation of the Ad Hoc Committee at its December 14, 2005 meeting, and approved the SERP at its June 28, 2006 meeting.

On June 28, 2006, Blue Cross and Milnes entered into a new employment agreement dated as of June 28, 2006 ("Employment Agreement") and entered into the SERP. They were intended to comply with the recently-enacted provisions of Section 409A of the Internal Revenue Code and to update the documentation to reflect the then-current level of compensation.

The Employment Agreement provided that Milnes would be employed as President and Chief Executive Officer at a base compensation of $475,000, which also could be increased but not decreased. Employment Agreement at 1. The Employment Agreement also included a short-term incentive bonus of 25%-75% of base salary and a long-term incentive bonus of 16.67%-50% of base salary. Employment Agreement at 1-2. The term of the agreement was from March 26, 2006 to March 25, 2009, but was automatically extended each year by an additional

year unless the Board provided notice of intent not to extend the agreement. Employment Agreement at 1, 3. The agreement is governed by Vermont law. Employment Agreement at 9.

The SERP provided that Milnes was entitled to a supplemental retirement benefit over his lifetime equal to (1) 60% of the highest five years' average base and bonus compensation paid, payable or deferred during the last ten full years of employment less (2) qualified plan retirement benefits. SERP at 2-4. Milnes could elect to be paid in a lump sum or in any form of payment available under the Blue Cross qualified retirement plan. SERP at 3-4. Finally, the SERP stated that it was intended to provide benefits in excess of the limitations contained in the Internal Revenue Code and further stated that it shall at all times be entirely unfunded. SERP at 1, 5.

In connection with its compensation analyses, Blue Cross commissioned reviews of executive compensation by Mercer. It appears from the minutes and the Mercer Reports that executive salaries were targeted at the 25th percentile of benchmark companies and total cash compensation was targeted at the 50th percentile. *E.g.*, Committee meeting minutes dated December 18, 2002, and December 15, 2004. The benchmark companies typically consisted of other small Blue Cross and Blue Shield companies, and regional and national managed care and health care providers, with the resulting information compared to large Vermont corporations. Mercer Report dated February 27, 2008 at 27-29; Mercer Report dated February 1, 2006 at 5-15.

The Deloitte Report found that Blue Cross executive compensation, including base salary, incentive compensation and benefits, was reasonable, and at a level necessary to attract executives with the appropriate talent and experience. Deloitte Report at II-75. It found that total remuneration for Blue Cross executives (base, short and long term incentives) was 24% below the median of health care and insurance companies with similar revenues and number of employees, including other Blue Cross and Blue Shield and not-for-profit organizations. Deloitte Report at II-73.[5] The report did, however, indicate that the short term incentive goals should be simplified, oriented toward growth and financial performance, and recalibrated to provide clear stretch goals, that the long term goals should be set just prior to the performance period and that the membership level goal should increase over time, rather than remaining relatively flat. Deloitte Report at 114, II-75-76.

Mercer Reports addressing CEO-specific compensation were provided to the Executive Committee at least for the period December, 2003-March, 2008. These reports provided

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[5] It concluded, however, that a greater percentage of executive compensation (and specifically CEO compensation) was paid in base salary, and a lesser percentage in long term incentives, compared to the market. Deloitte Report at II-71.

increasingly detailed analyses of Milnes' base, incentive and total compensation relative to benchmarked companies. One presentation, for instance, indicated that over the prior six years, CEO cash compensation was 7%-13% below the 25th percentile, but that total cash compensation had generally been between the median and 75th percentile. Mercer report dated October 23, 2006 at 4. A later report stated that "[t]otal remuneration including compensation and executive benefits is aligned with the market median." Mercer Report dated February 27, 2008 at 20.

With respect to supplemental retirement benefits, the Mercer analyses addressed the basic features of the SERP, and in several instances, identified the projected annual or lump sum SERP payout or compared the features of the Milnes SERP to those of other companies. For instance, the Mercer Report identified above found that the features of the SERP were at or above market,[6] but that because total direct compensation was below market average, total remuneration (including total direct compensation and retirement benefits) was at the market median. Mercer Report dated February 27, 2008 at 43.[7] Two other reports quantified projected SERP payouts. Mercer Report dated October 23, 2006 at 9 (age 65 target consisting of projected annuity of $544,000 and lump sum equivalent of $5,195,000); Mercer Report dated February 28, 2005 at 6 (projected annuity of $402,944).

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[6] The report analyzed the SERP together with the Executive Deferral Program dated as of January 1, 2005, which provided for supplemental matching of CEO 401(k) contributions. The report found that the SERP was (1) slightly above market with respect to benefit target, primarily due to the Executive Deferral Program, (2) above market as to plan offsets (due to the lack of a Social Security offset) and as to eligible pay (due to inclusion of the long term incentive in final average pay), and (3) within market as to early retirement and form of payment. Mercer Report dated February 27, 2008 at 41.

[7] The basic provisions of the SERP are similar to the corresponding provisions of the Blue Cross qualified retirement plan. The major differences are as follows: (1) the qualified plan provides for annual payment equal to 2% of final average pay for each year of service up to 30 years (ie. 60% maximum), (2) the qualified plan requires that the five highest years of earnings (out of the last ten) be consecutive whereas the SERP does not, (3) the qualified plan offsets the annual payment obligation by 1.667% of the deemed age 65 Social Security benefit times years in service (up to 30), whereas the SERP does not, and (4) the compensation under the qualified plan is based on actual earnings during the relevant year whereas SERP compensation is based on compensation payable during the year (thereby annualizing compensation in partial years).

Blue Cross accrued the SERP obligations, together with its other post-retirement payment obligations, on its financial statements filed annually with BISHCA, and expensed the balance when paid. For instance, the December 31, 2006 statement indicated that the accrued obligation as of the end of 2006 was approximately $3 million, an increase of over $600,000 from the previous year. 2006 Annual Financial Statement to BISHCA at 25.6.[8] It further stated that Blue Cross expected to pay annual pension benefits totaling $555,000 in 2007 and escalating to $1,425,000 in 2011. The December 31, 2007 statement indicated that approximately $3.7 million had been accrued, and the 2008 amount was approximately $240,000. The reduction between 2007 and 2008 was expensed in 2008, although the amount does not appear as a separate line item on the 2008 Summary of Revenue and Expenses.

In its Report of Statutory Examination of Blue Cross as of December 31, 2005 ("Statutory Report"), BISHCA stated that Blue Cross established the SERP for its president in 1999, "which is designed to offset certain federal restrictions which limit benefits for highly compensated employees. The president is fully vested in his SERP's benefits. The liability for the SERP was $2.4 million at December 31, 2005." Statutory Report at 8. In connection with BISHCA's due diligence relating to the Statutory Report, Blue Cross provided responses to information requests relating to the SERP and executive compensation. This information included a description of how the SERP benefit is calculated (*e.g.*, 60% of final average pay). Response to Request 18 (Oct. 18, 2006) at Exh. A. It also included a description of the information used to set Milnes compensation, including the Mercer reports. *Id.*, Exh. C. The Statutory Report did not include any analysis or recommendations concerning the level of compensation for Milnes. BISHCA was also provided with a copy of the Deloitte Report and Presentation. BISHCA has not explicitly and formally approved the SERP, or any of Blue Cross' other retirement plans.

On November 18, 2008, Blue Cross and Milnes entered into a letter agreement ("Retirement Agreement") that, among other things, (1) confirmed Milnes' voluntary early retirement effective November 30, 2008, (2) provided for post-employment participation in the short-term and long-term incentive programs, and (3) effected a waiver by Milnes of any employment-related claims. The Milnes SERP benefit of approximately $6.5 million was paid

[8] Because the SERP was the only supplemental executive retirement plan until late 2005, almost all of the accrued liability related to the SERP. The amount identified in the financial statement was calculated on a net present value basis, whereas the amount calculated in the Mercer Report dated October 23, 2006 was calculated as of age 65.

on a lump sum basis on December 8, 2008.[9] The amount of the SERP payment obligation was not directly affected by the level of Blue Cross' income or profit.[10]

Through a series of written and verbal communications between counsel for Blue Cross and Milnes beginning on July 17, 2009, Blue Cross requested that Milnes voluntarily return a portion of the SERP payment. Milnes declined the request.

On November 3, 2009, the Commissioner of BISHCA denied various Blue Cross rate increase filings. *In re Blue Cross Blue Shield of Vermont*, Docket No. 09-131-H (November 3, 2009) ("BISHCA Order"). In the decision, the Commissioner stated that:

> [she] continues to be exceedingly troubled by the award to the Company's former Chief Operating Officer [sic] of over $6 million upon his retirement in December 2008. The Commissioner concludes that there is cause to believe that this excessive monetary award is contrary to the insurance laws of this state, contrary to the laws regulating the Company and its obligations to subscribers, and contrary to the Company's obligations to its subscribers as a non-profit corporation.

BISHCA Order at 5. The Order further required Blue Cross to show cause

> why the Commissioner should not issue the following reasonable supplemental orders ... necessary to insure that benefits and services are provided to subscribers at minimum cost under efficient and economical management of the Company and to insure that the Company is maintained and operated solely for the benefit of subscribers ... Should the Company be ordered to file an approved plan to recover that portion of the post-employment compensation of the Company's former Chief Executive Officer deemed by the Commissioner to be excessive under the insurance laws of this state, under the health insurance laws specifically applicable to the Company, and under Vermont's non-profit corporation laws.

BISHCA Order at 6.

III. LEGAL ANALYSIS

The analysis below addresses (1) whether BISHCA has authority to require Blue Cross to seek recovery of or recover the SERP payment and (2) whether attempted recovery would be successful on the basis identified in the Order. Resolution of the second issue depends on whether the SERP is enforceable, whether it is subject to unilateral modification and, even if

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[9] The difference between the $6.5 million payment and the 2007 valuation of $3.7 million was primarily due to changes in interest rates, an additional period of compensation, variation between the assumed and actual retirement date, and the fact that the 2007 valuation reflected a delayed recognition of prior changes in underlying assumptions (such as the preceding factors), due to an actuarial convention known as smoothing.

[10] The amount of the SERP was indirectly affected by the level of incentive compensation, which was based in part on Blue Cross' profitability.

there were a basis for invalidation or modification, whether Milnes is entitled to retain the SERP payment. The insurance and nonprofit laws identified in the Order affect resolution of both issues, and therefore the analysis follows the sequence identified in the Order: the general insurance laws applicable to BISHCA and Blue Cross, the health insurance laws specifically applicable to Blue Cross, and Vermont's nonprofit corporation laws. The analysis then addresses Milnes' ability to retain the SERP payment in the event recovery is sought.

As indicated below, BISHCA likely has the authority to require Blue Cross to seek recovery of the Milnes SERP payment, pursuant to its powers under 8 V.S.A. § 4513(c) to insure that benefits and services are provided at minimum cost under efficient and economical management of the corporation. BISHCA does not, however, have authority to require Blue Cross to obtain recovery of the SERP payment, because (among other reasons) required recovery is neither expressly authorized under the applicable statutes, nor impliedly necessary to achieve BISHCA's regulatory goals, and because compliance with the requirement is beyond Blue Cross' control. Required recovery would also likely constitute an unconstitutional impairment of contract by BISHCA. It also appears that any attempt to recover the SERP payment is likely to be unsuccessful. If (notwithstanding the analysis below) the SERP payment were found to be contrary to the statutes reviewed herein, based on Vermont precedent and applicable treatises, it appears likely that Milnes could retain the payment, except that Blue Cross may be able to recover any amount in excess of the reasonable value of Milnes' SERP-related services if the payment were deemed not protected by the business judgment rule or a violation of Milnes' fiduciary obligations as an officer.

As an initial matter, it should be noted that the SERP is a contract between Blue Cross and Milnes and therefore enforceability depends on principles generally applicable to contracts, subject to the insurance and nonprofit corporation laws addressed herein.[11]

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[11] Although supplemental executive retirement plans are commonplace in the United States, our research has revealed relatively few cases in which the enforceability of a SERP was directly challenged. Prominent among these are the Grasso and Jews cases. *People ex rel. Spitzer v. Grasso*, 21 A.D.3d 851, 801 N.Y.S.2d 584 (NY Supreme Court, 2005) ("Grasso I"); *People v. Grasso, Kenneth G. Langone, et al.*, 42 A.D.3d 126, 836 N.Y.S.2d 40 (Appellate Division, 1st Dept., 2007.); aff'd, *People v. Grasso*, 11 N.Y.3d 64, 893 N.E.2d 105, 862 N.Y.S.2d 828 (Appellate Division, 1st Dept., 2008) ("Grasso II"); *People ex rel. Spitzer v. Grasso*, 54 A.D.3d 180, 861 N.Y.S.2d 627 (N.Y., 2008) ("Grasso III"); *In re: Petition of William Jews*, No.: C-08-8557 (Baltimore Cty Cir. Ct. (for Consolidated Case (No. 10, 2009) (unpublished).

In Grasso, the New York Attorney General sued the CEO of the New York Stock Exchange ("NYSE"), among others, for recovery of compensation paid to him. The claims against the CEO were contained in six counts, two of which were brought under specific provisions of New York's Not-For-Profit Corporation Law ("N-PCL") permitting the attorney general to seek recovery of unreasonable compensation, N-PCL §§717, 720, and the other four counts related to other provisions of the N-PCL relating to claims that the CEO's compensation is ultra vires, constituted unjust enrichment, constituted an unlawful loan, and was not properly authorized by NYSE. Although resulting in a total of four decisions by the New York Supreme Court, the Appellate Division and the Court of

A. GENERAL BISHCA REGULATORY STATUTES

BISHCA's general regulatory authority is set out in 8 V.S.A. Chapter 1, and arises primarily under 8 V.S.A. §§11(a)(1), 15. Under 8 V.S.A. §11(a)(1), BISHCA "shall have jurisdiction over and shall supervise ... insurance companies ... and other similar persons subject to the provisions of this title." Section 11(a) identifies the types of entities over which BISHCA has jurisdiction, including Blue Cross, and confers supervisory authority over those entities. Under 8 V.S.A. § 15, "the commissioner may ... issue orders as shall be authorized by or necessary to the administration of [title 8] and Title 18, chapter 221, and to carry out the purposes of such titles."

Neither Section 11 nor Section 15 explicitly describes the extent of BISHCA's supervisory powers. The limitations on its regulatory authority have, however, been addressed more generally. A "public administrative authority has only such powers as are expressly granted by the Legislature, together with those implied as necessary for the full exercise of those granted." *New Hampshire – Vermont Physician Service v. Commissioner, Department of Banking & Insurance*, 132 Vt. 592, 596 (1974). *See In re Club 107,* 152 Vt. 320, 323 (1989); *Trybulski v. Bellows Falls Hydro-Electric Corp.,* 112 Vt. 1, 7 (1941). The extent of BISHCA's "necessarily implied" authority depends upon the type of activity being addressed, and is more limited where the activity is typically within management's discretion. In the analogous context of Vermont Public Service Board regulation, for instance, the Court held that "[t]he function of a public service commission is that of control and not of management, and regulation should not obtrude itself into the place of management." *In re New England Tel. & Tel. Co.*, 115 Vt. 494, 510 (1949).

For these reasons, Sections 11 and 15, by themselves, do not authorize BISHCA to require Blue Cross to recover a portion of the Milnes SERP payment on the basis that it is excessive. Instead, the standards explicitly or implicitly contained in these statutes must be applied to the more specific authority of BISHCA contained elsewhere.

Appeals, the case never reached trial on the merits. Instead, most of the claims were dismissed due to lack of attorney general standing (resulting from NYSE's conversion to a for-profit entity while the case was pending) and summary judgment in favor of the attorney general was reversed as to the remaining claim.

In Jews, the Court reversed a decision of the Maryland Insurance Commissioner reducing compensation in connection with termination of a health insurer executive from $17 million to $8.5 million. The Court held that the compensation did not violate a Maryland statute requiring that compensation be reasonable, and that the Commissioner's order was unsupported by the evidence, was arbitrary and capricious, was preempted by ERISA, and violated the executive's procedural and substantive due process rights.

B. STATUTES RELATING TO INSURANCE COMPANIES

BISHCA's authority over insurance companies is contained in Chapter 101. The chapter includes provisions relating to (1) company formation, reorganization and holding companies, (2) foreign companies, investments and loans, (3) investments, loans, reserves, deposits and pensions, (4) filing and approval of insurance forms, (5) reports, (6) specialized types of insurance, and (7) miscellaneous issues.[12]

It appears that the only relevant provision of Chapter 101 relates to pensions. In particular, 8 V.S.A. §3504 provides that an "insurance company ... may provide a pension in pursuance of the terms of a retirement plan, adopted by its board of directors and approved by the commissioner, for any person who is or has been an employee of such company, and who shall retire by reason of age or disability."[13] The statute does not apply to pensions not associated with a retirement plan. 1938-40 Op. Atty. Gen. 133. Although the statute does not define "retirement plan," it appears likely that based on the common meaning of the term, the SERP is a retirement plan, based on comparable analyses under the Employee Retirement Income Security Act of 1974 ("ERISA"), because it is an arrangement that provides benefits triggered by retirement. The fact that the SERP extends only to a single person is not dispositive. *Biggers v. Wittek Indus.*, 4 F.3d 291, 297-298 (4th Cir.1993) (plan can be limited to one person).

It appears, however, that Section 3504 does not preclude payment of the SERP. Section 3504 authorizes an insurance company to pay a pension under an approved retirement plan. Importantly, this authority is provided "in addition to all other powers granted to [an insurance company] by law." In other words, it does not appear to require BISHCA approval of an otherwise authorized plan; it merely confers additional authority to adopt a retirement plan.[14] As discussed in more detail below, Blue Cross clearly has separate authority to establish and make payments under pension, incentive and other benefit plans. 11B V.S.A.§ 3.02 (11), (12). As a

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[12] BISHCA's authority over health insurance companies is set forth in Chapter 107. Most of the provisions of the chapter relate to required provisions in health insurance policies and the process for approval or disapproval of insurance forms. There do not appear to be any provisions that are directly applicable to the issues addressed herein.

[13] It also provides that "if such employee shall contribute to a retirement fund established under such retirement plan, and shall thereafter retire from the service of the company for reasons other than age or disability, the employee may withdraw from such fund the amount of the employee's contribution thereto with interest thereon at such rate, if any, and subject to such rules and regulations, as may be provided by the board of directors."

[14] The act which added the predecessor to Section 3504 was entitled "An act to authorize domestic insurance companies to establish a pension system." 1929 Vt. Acts No. 103. *See* 1938-40 Op. Atty. Gen. 133 ("A domestic insurance company is authorized by Section 6970 of the Public Laws [predecessor to Section 3504]to provide a pension").

result, Section 3504 does not require Blue Cross to obtain BISHCA approval before making payments under the SERP.[15]

It is also does not appear that Blue Cross is within the scope of Section 3504 because it is likely not an "insurance company ... organized and doing business under the laws of this state." It is not organized under the statutes that govern the organization of insurance companies. Chapter 101, Subchapter 1. Instead it was organized under Chapter 123, which governs corporations "organized for the purpose of establishing, maintaining and operating a nonprofit hospital service plan whereby hospital care may be provided by a hospital maintained by a corporation organized for such purposes ... [to subscribers] under a contract which entitles each subscriber to certain hospital care." 8 V.S.A. §4511.[16] The organization of Blue Cross also did not meet the requirements for organizing a domestic insurance company. A Vermont-chartered insurance company must obtain a certificate of public good before submitting its articles of association to Secretary of State. 8 V.S.A. §3305. A certificate of public good is not a requirement for hospital service corporations formed under Chapter 123, 8 V.S.A. §4512, nor did Blue Cross obtain such a certificate before commencing operations. There also must be at least 15 incorporators of a Vermont-chartered insurance company, whereas there were three incorporators of Blue Cross.[17]

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[15] Section 3504 is also arguably inapplicable based on the facts underlying the Milnes SERP payment. Section 3504 applies to a pension provided to "any person ... who shall retire by reason of age or disability." Milnes did not retire by reason of age or disability. Instead, he chose to resign prior to normal retirement age for reasons other than a disability. Under the Employment Agreement, disability is defined as the inability to perform duties for six consecutive months due to illness, accident or otherwise, provided that the employee does not return to full-time employment within 30 days after termination. Milnes was performing his duties at the time of resignation.

[16] In other states, companies providing hospital or medical services have been found not to be engaged in the business of insurance. *See Group Life & Health Ins. Co. v. Royal Drug Co.*, 440 U.S. 205, 217 (1979)(Blue Shield agreements with pharmacies are not the "business of insurance"); *Michigan Hospital Service v. Sharpe*, 339 Mich. 357, 63 NW2d 638 (1954) (company is not an insurer where it contracts for the provision of medical services to its members but does not insure against a hazard or peril); *Jordan v. Group Health Ass'n*, 107 F.2d 239 (D.C. Cir. 1939) (entity undertaking to provide medical services to its members is not an insurance company); *Comm'r of Banking & Insurance v. Community Health Service*, 129 NJL 427, 30 A.2d 44 (1943) (company is not an insurer where it is not licensed as an insurer, it contracts with physicians to provide services to members, it does not indemnify members against loss due to the happening of a contingency, and members incur no debt to the physician).

[17] Other provisions of Chapter 123 distinguish between hospital service corporations and insurance companies. *E.g.* Section 4517 (limitation on investment by hospital service corporation in an insurance company), Section 4523 (commissioner approval of any acquisition of an insurance company by Chapter 123 company). In addition, other provisions explicitly include nonprofit hospital service corporations within the scope of "insurer," for purposes of specific issues, thereby implying that without the specific inclusion, the definition of insurer would exclude hospital service corporations. 8 V.S.A. § 4088h ("'health insurance plan' means any ... hospital or medical service corporation ... subscriber contract"); 18 V.S.A. 9402(8)("'health insurer' means any ... nonprofit hospital and medical service corporation ..."). Another statute, however, specifically excludes a hospital service corporation from the definition. 8 V.S.A. § 3681(5) ("'insurer' ... shall not include nonprofit hospital or medical service corporations").

The fact that Blue Cross might be deemed to be providing insurance for some purposes,[18] does not mean that it is an insurance company for purposes of Section 3504. *See Royal Drug*, 210-11 (1979) (distinguishing between business of insurance and insurance companies); *Cleveland Hospital Service Ass'n v. Ebright*, 142 Ohio St. 51, 49 N.E.2d 929 (1943)) (although hospital service corporation provided services tantamount to insurance, it was not an insurance company for purposes of a franchise tax on insurers, because it was subject to a separate tax). Thus the facts that (1) the 2005 Statutory Examination by BISHCA was undertaken under the authority of 8 V.S.A. § 3563, which provides that the Commissioner shall examine the affairs of each domestic insurers every three years and (2) Blue Cross' annual report is submitted pursuant to 8 V.S.A. §3561, which applies to insurers, does not compel a conclusion that Blue Cross is an insurance company for purposes of Section 3504.[19]

It is also unlikely, moreover, that Section 3504 was intended to include entities organized under Chapter 123. Section 3504 was enacted in 1929, prior to the 1939 enactment of Chapter 123,[20] and the statute providing for organization of Chapter 123 companies, Section 4511, does not include a reference to insurance.

For these reasons, Title 101 does not authorize BISHCA to require Blue Cross to seek recovery of the Milnes SERP payment.

C. STATUTES RELATING TO HOSPITAL SERVICE CORPORATIONS

As indicated above, Blue Cross was organized under the provisions of Chapter 123. Under 8 V.S.A. §4513(c):

> In connection with a rate decision, the commissioner may also make reasonable supplemental orders to the corporation and may attach reasonable supplemental conditions and limitations to such orders as he finds, on the basis of competent and substantial evidence, necessary to insure that benefits and services are provided at minimum cost under efficient and economical management of the

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[18] Insurance is defined to mean "an agreement to indemnify or otherwise assume an obligation, provide services or any other thing of value on the happening of a particular event or contingency, ... [and] shall include any business defined in section 3301 of this title, annuity contracts and the business of health maintenance organizations and continuing care retirement communities." 8 V.S.A. § 3301a.

[19] Even if the terms of Section 3504 were construed to require Commissioner approval of the Milnes SERP payment, there is a reasonable basis for finding that BISHCA's actions should be deemed either to constitute approval of the SERP or to constitute a waiver or estoppel, preventing the Commissioner from claiming that approval had not been provided. Section 3504 does not identify the required form of BISHCA approval, unlike other statutes. *E.g.*, 8 V.S.A. § 3541 (BISHCA may, by order, affirmatively disapprove an insurance form). Although there is no documentation that BISHCA formally approved the SERP, it had knowledge of many of the SERP's material terms and of the amount of the SERP obligation, and it did not notify BISHCA that it objected to the accrual of the SERP obligation on the Blue Cross books.

[20] 1939 Vt. Acts No. 174.

> corporation ... [but the] commissioner shall not set the rate of payment or compensation paid by the corporation to any physician, hospital or other health care provider.

Section 4513 relates to hospital service corporations; a substantively identical requirement applies to medical service corporations. 8 V.S.A. §4584(c).

Section 4513 was analyzed at length by the Vermont Supreme Court in *In re Vermont Health Service Corp.*, 144 Vt. 617 (1984). It stated that Section 4512(a), which provides that a hospital service corporation shall be maintained and operated solely for the benefit of subscribers, "articulates a legislative purpose to entrust the public interest in obtaining reasonably priced hospital care to the protection of the commissioner." 144 Vt. at 624. If BISHCA "is to fulfill its mandate of securing reasonably priced subscriber rates for hospital care ... [then] it must have the regulatory means to oversee the contracting process in which those rates are determined." 144 Vt. at 624. Section 4513(c) was "intended to provide the commissioner with the regulatory tools to achieve supervisory authority over Blue Cross's contracting process." 144 Vt. at 625. Based on this analysis, the Court affirmed BISHCA's authority to order Blue Cross to either cancel contracts with participating hospitals, or to reform them[21] to include methods for evaluating the efficiency of hospitals, procedures for eliminating reimbursement for unnecessary services and experience reporting data. 144 Vt. at 620.[22] If BISHCA's authority were limited to passive rate approval or disapproval, the Court stated, the commissioner would "not have the means actively to bring ... about" its mandate to "ensure that subscriber rates were not excessive, inadequate or unfairly discriminatory." 144 Vt. at 625-26.[23] The Court reiterated, however, the statutory requirement that BISHCA's exercise of Section 4513 authority must be "in connection with a rate decision, be based on competent and substantial evidence, and be reasonable." 144 Vt. at 625.[24] It also stated that the reasonableness must be assessed in the context of the statutory purpose it is intended to achieve. *Id.* In a subsequent case, the Court affirmed BISHCA's authority to require approval of capital expenditures in excess of $250,000. *In re Vermont Health Service Corp.*, 155 Vt. 457 (1990). It

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[21] Contract reformation typically involves a judicial modification of a contract based on mutual mistake, rather than on public policy grounds. *Cassani v. Northfield Savings Bank*, 179 Vt. 204, 210, 2005 Vt. 127, ¶ 15 (2005).

[22] The BISHCA order reflected a modification from an earlier order solely requiring reformation, which Blue Cross challenged as impractical. 144 Vt. at 620.

[23] The Court's analysis is the same as the "necessarily implied" powers associated with 8 V.S.A. §11.

[24] Neither the reasonableness of the appealed BISHCA order, based on the facts of the case, nor the evidentiary basis for the order, was challenged on appeal. 144 Vt. at 625. Instead the challenge was limited to a broader, conceptual challenge to the scope of Section 4513 authority.

found that the requirement was necessary to achieve the goal of providing services at minimum cost under efficient and economical management, because Blue Cross was in "such a fragile debt position [that] large capital expenditures were very likely to have a major impact on 'Blue Cross'] financial position." 155 Vt. at 463. These cases demonstrate that BISHCA has implied authority to require approval of certain types of prospective arrangements and to require Blue Cross to exercise certain contractual rights in a specified manner, where necessary to achieve the goal of efficient operations.[25]

Although BISHCA has authority to require Blue Cross to seek recovery of the SERP payment, for the following reasons it is highly likely that Section 4513 does not authorize BISHCA to require recovery of the Milnes SERP payment. First, such an order would go well beyond the level of authority reviewed above. Rather than requiring the regulated entity to enter into or reject a proposed arrangement, or to exercise contractual rights under an existing contract, a requirement to recover the SERP payment would mandate an action that is not within the ability of Blue Cross to achieve. As a result, such a requirement would not meet the statutory requirement of reasonableness.

Second, mandated recovery of the SERP payment appears to be contrary to legislative intent. Even though arrangements between Blue Cross and health care providers are central to the goal of "obtaining reasonably priced hospital care." 144 Vt. at 624-25, Chapter 123 prohibits BISHCA from prescribing the rate of payment or reimbursement made by Blue Cross to any physician, hospital or other health care provider. 8 V.S.A. §4513(c). The setting of executive compensation reflects the type of action that is normally afforded greater management discretion. In connection with a requested rate disallowance due to allegedly excessive rates, for instance, the Vermont Supreme Court stated as follows:

> [the] matter of salaries ... calls for the exercise of judgment on the part of the management of the company. Good faith on its part is to be presumed. Although such expenses should be scrutinized with care by the commission they should not be disallowed or reduced unless it clearly appears that they are excessive or unwarranted or incurred in bad faith.

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[25] In analogous contexts, an administrative agency has similar authority to require regulated entities to enter into new contracts. For instance, electric utilities are required to enter into contracts to purchase power from certain types of renewable generation projects at prescribed rates. 30 V.S.A. §8005(b)(6). Similarly, so-called incumbent local exchange carriers are required to interconnect their telecommunications networks with others, pursuant to contracts containing specified terms. 47 U.S.C. §252(b). These types of obligation are qualitatively similar to an agency's ratemaking authority, pursuant to which the regulated entity is required to offer to provide service at rates, terms and conditions prescribed in advance by the agency. *E.g.* 8 V.S.A. §§4512-13. Unlike BISHCA's section 4513(a) authority, moreover, these provisions (1) contain express statutory authority to require new contracts, (2) are limited to arrangements sought by the contract counterparty and (3) the major terms are specified by statutory criteria.

New England Tel., 115 Vt. at 511. As a result, it would be illogical to conclude that the legislature intended to permit BISHCA to retroactively modify compensation arrangements with Blue Cross employees while preventing it from prospectively prescribing arrangements with health care providers.

Third, retroactive modification of an existing contract is likely not impliedly necessary to achieve the statutory goal of reasonably priced subscriber rates for health care. The goal could be readily achieved by means of prospective guidance pursuant to clearly-articulated requirements, such as those adopted in the above BISHCA orders affirmed by the Court, rather than the far more burdensome, disruptive and intrusive mandate to retroactively achieve goals not identified in advance. BISHCA also has authority to protect subscribers by rejecting proposed rates that are excessive, inadequate or unfairly discriminatory.[26] 8 V.S.A. §§4512(b), 4513(b), (d).

Even if BISHCA had authority to require recovery of the SERP payment, for instance under 8 V.S.A. §4513(c), it is likely that such an action would violate the Contract Clause of the United States Constitution. Under Article I, Section 10 of the United States Constitution, "[n]o State shall ... pass any ... Law impairing the Obligation of Contracts." The Contract Clause precludes legislation and legislative actions that unreasonably impair contractual obligations. *Allied Structural Steel v. Spannaus*, 438 U.S. 234 (1978). An order of a State agency exercising delegated legislative authority "is of the same force as if made by the legislature, and so it is a law of the state within the meaning of the contract clause of the Constitution." *Grand Trunk Western Railway co. v. Railroad Commission of Indiana,* 221 U.S. 400, 403 (1911). BISHCA's authority to issue supplemental orders under Section 4513 arises in connection with its authority to regulate the rates contained in subscriber contracts. "[R]atemaking is a legislative function delegated to" the administrative agency. *In re New England Tel. & Tel. Co.*, 135 Vt. 527, 540 (1977). As a result, administrative ratemaking directives to modify contracts[27] reflect an exercise of legislative powers within the scope of the Contract Clause.

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[26] The typical level of BISHCA review of a rate filing, however, appears to be significantly less than, for instance, Public Service Board review of utility rates. There are also limits on the extent to which rates can be reduced, both as a constitutional matter, *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 307-308 (1989) (a highly inadequate rate may deprive the utility of its property without due process of law), and as a practical matter. Publicly-owned entities do not have access to funds supplied by equity investors that can offset the impacts of rate reductions.

[27] A directive requiring a contract party to act in a manner inconsistent with the contract would appear to be tantamount to a required modification of the contract.

Legislative action violates the Contract Clause if it impairs the contract and is not reasonable or necessary to achieve an important public purpose. *United States Trust Co. v. New Jersey*, 431 U.S. 1, 17, 25 (1977). With respect to pension-related modifications, although an employee's vested pension rights may be affected through a modification of a pension plan in certain circumstances, it appears that an unreasonable impairment arises where an adverse impact is imposed on an employee after retirement, if it is not accompanied by a comparable new advantage. *Burlington Fire Fighters Ass'n v. City of Burlington*, 149 Vt. 293, 298 (1988). As a result, to the extent that BISHCA were authorized by statute to require Blue Cross to recover the SERP payment, there would be a reasonable basis for finding that the requirement violated the Contract Clause.

Finally, even if BISHCA had authority to require recovery of past payments deemed to be excessive, the facts associated with the Milnes SERP support a conclusion that recovery is not justified on this basis. The terms of the SERP were generally similar to the terms of the qualified plan retirement benefits. Although the SERP payment itself was above market, Milnes' total compensation was well within the market. It would appear unreasonable to require recovery of one compensation component, on the grounds that it was excessive, if it results in overall compensation that is below market. In this regard, the circumstances associated with the SERP payment appear to be far different than context relating to required approval of certain capital expenditures, where Blue Cross was experiencing significant financial duress.

For these reasons, Section 4513 does not provide the requisite authority to require Blue Cross to seek recovery of past payments, the exercise of any such authority would constitute an unconstitutional impairment of contract and, in any event, the amount of the payment is within the range of reasonableness.

D. THE VERMONT NONPROFIT CORPORATION ACT

The corporate authority of Blue Cross is primarily governed by Vermont's Nonprofit Corporation Act, 11B V.S.A. Among other things, nonprofit corporations have general authority to appoint officers, to fix their compensation, "to pay or contribute to pensions and establish pension plans ... and any other benefit and incentive plans for ... current or former ... officers." 11B V.S.A. §3.02 (11), (12).[28] Therefore Blue Cross has explicit statutory authority to establish and make payments under pension plans.

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[28] The authority of a nonprofit corporation like Blue Cross to establish pension plans and make pensions thereunder is no different than the authority of for-profit corporations. 11A V.S.A. §3.02 (110), (12). *See* 6 *Fletcher Cyclopedia Corporations* §2552.10 at 429-31. Unlike statutes in other states, this statutory authority to incur pension obligations does not expressly require that employment-related compensation must be reasonable in

There appear to be four possible claims that the amount of the SERP payment is contrary to the provisions of Title 11B: (1) the amount of the SERP payment is excessive in relation to the services performed, (2) the SERP is a conflicting interest transaction (due to Milnes' position as a director) and the requirements for approval of such transactions were not met, (3) the directors breached their fiduciary obligations in approving the SERP, and (4) Milnes breached his fiduciary obligation as an officer in connection with approval of the SERP. As demonstrated below, there does not appear to be a reasonable basis for challenging the SERP payment under any of these standards.

Decisions by the Blue Cross directors with respect to executive compensation are governed by the business judgment rule and the directors' fiduciary obligations. The business judgment rule provides a rebuttable presumption that directors have acted in accordance with the applicable fiduciary standards. *Citron v. Fairchild Camera & Instrument Corp.*, Del.Supr., 569 A.2d 53, 64 (1989); *Aronson v. Lewis,* Del.Supr., 473 A.2d 805, 812 (1984).[29] Unless the presumption is rebutted,[30] a court will generally not disturb corporate decisions as long as they can be attributed to a rational business purpose. In connection with executive compensation, the business judgment rule protects such compensation unless it bears no reasonable relationship to the services rendered, such that the compensation is "so disproportionately large as to be unconscionable and constitute waste." 3A *Fletcher Cyclopedia Corporations* §1039 at 49.[31]

The SERP payment related to service provided by Milnes to Blue Cross and therefore related to a rational business purpose. Similarly, the payment is not unconscionable nor does it appear to be above the amount protected under the business judgment rule. Milnes' compensation, including the SERP, was set by reference to the compensation paid to CEO's in

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relation to the work performed for the corporation. *E.g.* MD. Code. Ann., Ins. Art. § 14-139 (applicable to nonprofit health service plans); N.Y. N-PCL §202(12) (applicable to nonprofit corporations generally).

[29] In general terms, the business judgment rule applies to nonprofit corporations to the same extent as to for profit corporations. *Janssen v. Best & Flanagan*, 662 N.W.2d 876 (Minn.,2003); *In re Midway Jewish Center*, 16 Misc.3d 607, 612, 838 N.Y.S.2d 879 (N.Y.Supr. Ct 2007); *but see Oberly v. Kirby,* 592 A.2d 445 (Del.1991) (directors of charitable corporations have a special duty to advance its charitable goals and protect its assets, and actions that threaten those goals are ultra vires). The authority of so-called quasi-public corporations is limited in other, unrelated respects. *See Vermont Dep't of Public Serv. v. Mass. Municipal Wholesale Elec. Co.*, 151 Vt. 73, 87 (1988)("MMWEC") ("quasi-public corporations [that] are private corporations to which the state has granted a secondary franchise for the performance of public duties" cannot delegate the power to incur debt to a third party).

[30] As addressed below, the presumption can be overcome if fraud is demonstrated or directors act in a manner inconsistent with their fiduciary obligations under 11B V.S.A. § 8.42.

[31] Waste requires a demonstration that the transaction is completely one-sided. *E.g., In re Walt Disney Co. Derivative Litigation*, 906 A.2d 27, 74 (DE 2006) ("'an exchange that is so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration,' or a situation where the defendants have 'irrationally squandered or given away corporate assets'); *Delta Star, Inc. v. Patton*, 76 F. Supp. 2d 617, 634-35 (W.D. Pa. 1999) ("a transaction on terms that no person of ordinary, sound business judgment could conclude represent a fair exchange").

benchmarked companies with similar characteristics. The SERP itself contains terms that are similar to other supplemental executive retirement plans and similar to the provisions of the Blue Cross qualified plan.[32] Although aspects of the SERP terms were more favorable than the market, his total remuneration was within a reasonable range identified by market studies and therefore was not so disproportionately large as to be unconscionable.

The business judgment rule does not apply, however, where an arrangement (among other things) was based on fraud, or board of director approval of an arrangement violated the prohibition against conflicts of interest or breached the directors' fiduciary duties. 3A *Fletcher Cyclopedia Corporations* §1040 at 52-53. With respect to conflicting interests, a contract in which a director of a mutual benefit corporation has an interest (such as Milnes' interest in the SERP) is valid (1) if it was fair at the time it was entered[33] or (2) if it was authorized, approved or ratified by a board or committee by a majority vote of nonconflicted directors, and the material facts of the transaction and the conflicting interest are known. 11B V.S.A. §8.31(a), (c)(1), (e).[34] The statute does not define what constitutes material facts, for purposes of the conflict of interest test. In the analogous context of a corporate director's disclosure obligations to shareholders, however, it has been found that an omitted fact is material if it would have assumed actual significance in the deliberations of the reasonable stockholder; that is, it would have been viewed as having significantly altered the total mix of information made available. *In re the Walt Disney Co. Derivative Litig.,* Del Ch., 731 A.2d 342, 376 (1998).

The SERP was approved by a majority of the disinterested members of the Committee at its December 14, 2005 and June 28, 2006 meetings.[35] With respect to knowledge of the material facts relating to the SERP, the Committee members regularly received an independent expert analysis of Milnes' total cash compensation, which formed the basis for calculation of SERP

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32 A nonprofit corporation is also precluded from making any amount of distributions (defined to include "any part of the income or profit of a corporation [paid] to its ... officers") unless to purchase memberships while solvent or in connection with dissolution. 11B V.S.A. §§1.40(10), 13.01-.02. This limitation does not apply to the Milnes SERP. The SERP obligation was unaffected by the level of Blue Cross profits and therefore did not constitute a distribution of part of Blue Cross' income or profit.

33 It is beyond the scope of this Report to assess whether the SERP was "fair," for purposes of Section 8.31.

34 The validity of the vote is not affected by the presence or participation in the vote by the conflicted director. 11B V.S.A. §8.31(e).

35 The minutes indicate that Milnes was not on the Committee at the time of either meeting. Under the Bylaws, the Committee has authority to act in the stead of the Board between the Board's annual meetings, and to address compensation matters. Bylaws, Section 211(b). CEO compensation and benefits were also reviewed b y the Board on a continual basis. Minutes of Board meetings dated March 22, 2006, January 24, 2007, March 28, 2007, August 22, 2007, March 22, 2008.

payments.[36] *E.g.*, Mercer Report dated February 1, 2006. They also received analyses of the SERP provisions and how they compared to comparable SERPs, and a calculation of the projected annual SERP payment obligation. *E.g.*, Mercer Report dated February 28, 2005 at 6. Even though it does not appear that a current lump sum value calculation of the Milnes SERP obligation was available to the Committee at the time it authorized the SERP, an approximation of the current amount could have been readily calculated from the annual amount and Milnes' life expectancy. As a result, there does not appear to be any basis for rebutting the presumption associated with the business judgment rule. For the same reason, there does not appear to be any basis for a claim that the statutorily-required process for approving a conflicting interest transaction was not followed.

Directors of a nonprofit corporation must act in accordance with their fiduciary obligations to act (1) in good faith, (2) with the care an ordinarily prudent person would exercise in similar circumstances and (3) in a manner reasonably believed to be in the best interests of the corporation. 11B V.S.A. §8.30(a).[37] The Vermont Supreme Court has held that "[t]he relationship of a director-stockholder to his corporation binds him to use the utmost good faith and loyalty for the furtherance and advancement of the interest of that corporation." *Lash v. Lash Furniture Co. of Barre, Inc.*, 130 Vt. 517, 522 (1972).

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[36] Under 11B V.S.A. § 8.30(b)(2), in discharging their duties directors are entitled to rely on reports by outside experts as to matters reasonably believed to be within the expert's competence.

[37] The standard is identical to the standard applicable to directors of for-profit corporations. *Compare* 11A V.S.A. §8.30(a) *with* 11B V.S.A. §8.30(a). With respect to compensation, a nonprofit corporation has the same interest as for-profit corporations in providing a level of compensation necessary to attract management; in both cases the necessary level of compensation is typically established through appropriate market-based benchmarks.

Blue Cross is also subject to the requirement that it "be maintained and operated solely for the benefit of the subscribers," and, in that regard, the Commissioner may adopt reasonable orders designed to assure that benefits are provided at a minimum cost under efficient and economical management. 8 V.S.A. §§4512(a), 4513(c). These provisions articulate "a legislative purpose to entrust the public interest in obtaining reasonably priced health care to the protection of the commissioner." *Vermont Health Service*, 144 Vt. at 624. They therefore appear to reflect, in part, a regulatory standard to be enforced by BISHCA, similar to the regulatory requirement that electric service be provided in a least-cost manner, which is enforced by the Public Service Board. *E.g.* 30 V.S.A. §218c(b). The subscriber benefit standard also limits the purpose of a hospital service corporation, which could otherwise be for any lawful purpose. 8 V.S.A. §§ 2.02(b)(1), 3.01(a). Although this standard arguably precludes Blue Cross from engaging in substantial activities for the benefit of unrelated constituencies, it is highly unlikely that it provides a benchmark for determining that employee compensation was not for the benefit of subscribers, unless (1) the employee's activities were unrelated to any subscriber benefit or (2) the compensation represented such a high portion of total costs and were so far above market as to suggest that the entity's operations were in part for the purpose of benefitting the employee. Even under these circumstances, it would appear principles of due process and the prohibition against vagueness would require more specific advance guidance, before such a general standard were used to determine that a specific activity was beyond the corporation's authority. *See Grayned v. City of Rockford*, 408 U.S. 104, 108-109 (1972); *Rutherford v. Best*, 139 Vt. 56, 60 (1980). The general standard of Section 4512(a) levels provides far less guidance with respect to compensation than, for instance, the standards underlying a director's fiduciary duty, such as the business judgment rule. *Cf.* 26 C.F.R. § 501(c)(3)-(1) (detailed regulations addressing activities that violate requirement that certain tax exempt organizations be organized and operated exclusively for specified purposes).

It appears that these obligations were met. As indicated above, it appears that the material information relating to the SERP payment (as well as total remuneration) was available to the Committee prior to the votes and therefore the duty of care was satisfied. The information reviewed does not suggest any basis for a breach of the duties of good faith or loyalty. As a result, it appears that the business judgment rule applied to the decision to approve the SERP and that the SERP obligation is well within the protection afforded by the rule.

An officer of a nonprofit corporation is also obligated to act (1) in good faith, (2) with the care an ordinarily prudent person would exercise in similar circumstances and (3) in a manner reasonably believed to be in the best interests of the corporation. 11B V.S.A. §8.42(a). Although not explicitly codified in the Vermont Nonprofit Corporation Act, it is likely that officers are subject to a duty of disclosure with respect to transactions requiring director approval, similar to a director's disclosure obligations to shareholders. *See Loudon v. Archer-Daniels-Midland Co.*, 700 A.2d 135, 143 (DE 1997). In this regard, corporate fiduciaries can breach their duty of disclosure by making a materially false statement, by omitting a material fact, or by making a materially misleading partial disclosure. *In re the Walt Disney Co. Derivative Litig.,* Del Ch., 731 A.2d 342, 376 (1998).

Based on the information reviewed, it does not appear that there is any basis for concluding that Milnes breached his fiduciary obligations. The information available to the directors relating to the SERP and Milnes' compensation was obtained from outside consultants and the information reviewed does not demonstrate that Milnes influenced the directors' actions relating to the SERP. As a result, there appears to be no basis for claiming that Milnes breached his fiduciary obligation as an officer by controlling the availability of SERP-related information or otherwise influencing the directors' decisions.

E. RECOVERABILITY OF THE SERP PAYMENT

The above analysis indicates that the SERP was a binding contract, was not subject to BISHCA approval under 8 V.S.A. §3504 or modification under 8 V.S.A. §4513, was not in excess of an amount protected under the business judgment rule, and its approval was not contrary to the fiduciary duties of directors or officers, or inconsistent with the requirements for a conflicting interest transaction. The following discussion addresses the likelihood that Blue Cross could succeed in recovering a portion of the SERP in the event that a court or other adjudicator were to disagree with the analysis set forth above and a reach a contrary conclusion. Whether the SERP payment is recoverable depends on whether the contract is unenforceable

and, if so, whether the remedy should include recovery of past performance. Resolution of both of these issues depends on the circumstances.

Section 3504 does not explicitly identify the consequences of failure to obtain BISHCA approval, such as precluding enforcement. The SERP may be unenforceable on policy grounds, however, if the interest in enforcement is clearly outweighed in the circumstances by a public policy against enforcement. *MacDonald v. Roderick*, 158 Vt. 1, 6-7 (1992); *Restatement (Second) of Contracts* §178(1) (1981).[38] Factors to be weighed in favor of enforcement include the parties' justified expectations, any forfeiture resulting from lack of enforcement and any special public interest in favor of enforcement. *Restatement (Second) of Contracts* §178(2) (1981). Factors to be weighed against enforcement include the strength of the public policy as manifested in legislation or judicial decisions, the likelihood that refusal to enforce would further the policy, the seriousness of the misconduct and the extent to which it was deliberate, and the directness of the connection between the misconduct and the contract to be enforced. *Id.* at §178(3).

These factors would appear to weigh against unenforceability with respect to Section 3504. Among other things, it appears that Blue Cross and Milnes expected the SERP to be performed, and we are unaware of efforts to require Section 3504 approval with respect to other retirement plans.

Even if the SERP were unenforceable in connection with Section 3504, it is not clear that Blue Cross would be entitled to recover the SERP payment. The usual remedy with respect to a contract that is void and unenforceable on grounds of illegality "is to leave the parties as the court finds them at the time the illegality is discovered, not to restore them to the same position they would have been had the contract never existed." *Jipac v. Silas*, 174 Vt. 57, 61-62 (2002). In such a case, unperformed contract obligations are not subject to enforcement and performed obligations are not subject to recovery. *Id.* Where the parties are not *in pari delicto* (*i.e.* equal culpability), however, equitable principles may permit the innocent party to recover any consideration given as part of the illegal transaction. 174 Vt. at 66-67. *See Restatement (Second) of Contracts* §198 (1981). It is highly unlikely that, in the event Section 3504 required BISHCA approval of the SERP, that Milnes would be found to be more at fault than Blue Cross (such as being more aware of the BISHCA approval requirement or the consequences of failure

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[38] The Court in *MacDonald* required payment of a real estate agent's commission, pursuant to a listing agreement that did not comply with regulatory requirements. In analyzing the issues, the Court chose not to apply a section of the Restatement providing that if a party is prohibited from doing an act due to failure to comply with a licensing, registration or similar requirement, the promise to do the act is unenforceable if the requirement has a regulatory purpose. *Restatement (Second) of Contracts* §181(a) (1981).

to obtain approval). Even if the parties were not in *pari delicto* thereby creating a basis for recovery, moreover, Blue Cross would likely be required to return to Milnes the value of his services related to the SERP, unless it is appropriate for Blue Cross to retain these amounts due to the nature of the Section 3504 violation or the need to deter future illegality. 174 Vt. at 67. Section 3504 can presumably be enforced in the future, however, by means of BISHCA's authority to impose sanctions, 8 V.S.A. §3301, even though this authority is subject to the same type of practical constraints affecting BISHCA's authority to reject rates that are excessive. For these reasons, any recovery of the SERP payment would likely be offset by the value of Milnes' services related to the SERP.

To the extent the SERP amount was determined to be in excess of the amount protected under the business judgment rule, it would appear reasonable to conclude that Blue Cross might recover as damages the excess over the protected amount. *Cf. Delta Star,* 76 F. Supp. 2d at 635 (corporation entitled to recovery of all compensation in excess of base salary because, among other reasons, recipient not entitled to any of the excess compensation on the basis of *quantum meruit*).

With respect to a conflicting interest transaction, 8 V.S.A. §8.31(a) provides that such a transaction is not voidable if approval met the requirements of the statute; [39] it thereby implies that a failure to comply with the approval requirements may render the transaction voidable. As a result, this provision appears to render the SERP payment unenforceable, even without the Restatement's balancing of interests that is applicable to the Section 3504 analysis.[40] For the reasons identified above, however, it appears that Blue Cross would not be entitled to recovery of the SERP payment (Blue Cross is not more innocent than Milnes with respect to the failure to comply with the conflicting interest transaction approval requirements) and, even if it were, the recovery would be offset by the value of Milnes' SERP-related performance.[41]

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[39] The section also provides that the transaction shall not subject the director to liability if the approval requirements are met. This provision would not provide a basis for recovery against Milnes in connection with his duties as a director, since he did not participate in the approval of the conflicting interest transaction. For the same reason, a determination that the directors' approval of the SERP violated their fiduciary obligations of care, loyalty or good faith, which also would result in potential director liability, 8 V.S.A. §8.30(d), would not provide a basis for recovery from Milnes.

[40] *Cf. MacDonald*, 158 Vt. at 63 (statute that renders certain contracts in conflict with Act 250 unenforceable, reflects a legislative balancing of the interests identified in the Restatement).

[41] Although Section 8.31(a) provides that the offending contract may be voidable, rather than void, it appears likely that the Court's Jipac analysis would still apply. The Court applied its analysis to illegal contracts, and did not indicate that a different remedy applies to voidable contracts. 174 Vt. at 61-62, 67-68. Other cases suggest, moreover, that the distinction between void and voidable relates to the contract's status before it is challenged as unenforceable, rather than to the type of remedy available. *See Progressive Ins. Co. v. Wasoka*, 178 Vt. 337, 343, 2005 VT 76, ¶ 12, n. 5 (2005) (a contract void *ab initio* is void from inception); *cf. In re Burlington Electric Dep't,*

Under 8 V.S.A. §8.42(d), an officer is not liable for action taken in compliance with the duties of loyalty, care and good faith. The statute thereby implies that Milnes may be liable if he breached his fiduciary obligations as an officer in connection with the SERP approval. In that event, Blue Cross would likely be entitled to recover its damages, which would appear to be the difference between the amounts actually paid and the amounts that would have been paid had Milnes not breached his fiduciary obligation.[42] Thus Milnes would presumably be entitled to retain an amount equivalent to the actual or reasonable value of his SERP-related services.[43]

Based on the above, it appears that recovery from Milnes on the grounds that the SERP payment is excessive may be available only if (1) the SERP payment amount is in excess of the amount protected by the business judgment rule, or (2) Milnes' breached his fiduciary obligations as an officer in connection with the transaction, in which case Blue Cross might recover a portion of the SERP payment. In that event, however, it is likely that Milnes would claim that Blue Cross is precluded from making such a claim under the principles of waiver and estoppel.[44]

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141 Vt. 540, 545 (1982) (voidable process is valid until attacked and an amendment is allowable to cure, whereas void process cannot be cured).

[42] *Cf. Berlin Development Corp. v. Vermont Structural Steel Corp.*, 127 Vt. 367, 370 (1968) (recovery for breach of contract "limited to the damage which fairly and reasonably may be considered as arising naturally from the breach of contract").

[43] In the event there were a basis for recovering the entire amount, Milnes could seek restitution under the principles of *quantum meruit* or unjust enrichment. These principles imply a promise to pay in the absence of a contract, where one party confers a benefit to another, the other accepts the benefit and retention would be inequitable. *DJ Painting, Inc. v. Baraw Enterprises, Inc.*, 172 Vt. 239, 242 (2001); *Metropolitan Stock Exchange v. Lyndonville National Bank*, 76 Vt. 303, 309 (1904). The measure of recovery under unjust enrichment is the value of the benefit actually conferred upon the defendant, whereas the measure under *quantum meruit* is the reasonable value of the benefit. *Id.*, 172 Vt. at 242, n. 2.

[44] Waiver involves a intentional relinquishment of a known right. *KPC Corp. v. The Book Press, Inc.*, 161 Vt. 145, 148 (1993). In a case where an employee's compensation was reduced by action of an agent lacking authority to bind the corporation, the Court held that the employee waived any claim to recover the incremental amount by accepting the reduced payments. *Powers v. Rutland Railroad Co.*, 88 Vt. 376, 395, 400 (1914). Here a reasonable argument may be made that Blue Cross waived its claims by voluntarily paying the full amount of the SERP. Equitable estoppel applies where the party to be estopped knows the facts and intends that his conduct be acted upon, and the party asserting estoppel must be ignorant of the true facts and must rely on the conduct of the other to his detriment. *Fisher v. Poole,* 142 Vt. 162, 168, (1982). It applies where "in all the circumstances of the case, conscience and duty of honest dealing should deny one the right to repudiate the consequences of his representations or conduct." *Neverett v. Towne,* 123 Vt. 45, 55 (1962).

Estoppel can be based on silence where there is an obligation to speak. See *Boston & Maine Railroad v. Howard Hardware Co.,* 123 Vt. 203, 211 (1962). For instance, where a firm waited to claim that it had overpaid for a portion of office renovation services until the contractor had completed the contractually required services, in order to induce the completion of those services, the Court held that the firm was estopped from seeking to recover the overpayment, stating that "[w]e believe that an obligation to speak was present here to ensure fair dealing and good faith." *Greenmoss Builders, Inc. v. King*, 155 Vt. 1, 7 (1990). Similarly, any recovery sought by Blue Cross would not occur until after Milnes completed his employment obligations. Under these circumstances, a court could reasonably find that it would be unfair not to enforce the SERP and that Blue Cross is thereby estopped from seeking recovery.

Exhibit B

GALLAGHER, FLYNN HUMAN RESOURCE SERVICES, LLC

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phone 802.863.1331 *fax* 802.865.4446 *online* www.gfc.com

April 8, 2010

Peter F. Young, Assistant General Counsel
Department of Banking, Insurance,
Securities and Health Care Administration
State of Vermont
89 Main Street
Montpelier, VT 05620-3101

Dear Mr. Young:

In response to your request that I review the documents you sent to me and offer my opinion on the methodology used to determine Mr. Milnes' compensation, I would offer the following thoughts:

1. Retirement Benefits: The general structure of Mr. Milnes' retirement benefits appears to be standard based on the information that I reviewed. None of that information, however, contained any discussion about the manner in which the SERP payout was calculated or whether it was appropriate to include long term incentive payouts in the definition of compensation. While I originally noted that the SERP target of 60% of final average salary seemed a little above average to me, I have since seen proprietary data from a similar industry that showed an average SERP replacement level of 58%. The appropriateness of the SERP payout would necessarily depend on the individual components that went into the calculation of final average salary, as discussed below.

2. Incentives: The short-term and long-term incentives are targeted as specific percentages of base salaries. The target percentages are typical for executives. The Deloitte report was critical of the fact that the payout on the bonus programs was typically above 100%, and they made a few recommendations. I concur with their recommendations; fewer goals and a recalibration of the plan so that 100%+ bonuses are not the norm would improve the plans. I understand from you that changes to the incentive plans have been made.

3. The Relationship between Base Salary and Total Cash Compensation: The BCBSVT Board set a compensation policy of paying its executives "a base salary at the 25th percentile for a comparable position; with the opportunity to receive up to the 75th percentile for outstanding performance based on attainment of short-term and long-term objectives." (From *CEO Compensation, Report of the Executive Committee, March 2007*) In my opinion, this objective is well-designed. If the incentive goals are appropriate, excellent total compensation should go hand-in hand with excellent organization performance. This is a classic pay-for-performance design. The crux of the matter is how excellent organization performance is defined.

4. Base Salary: The key issue in the timeframe under discussion is the retention of Mr. Milnes. Compensation theory presumes that if total compensation is competitive, any reason for someone to leave a position would not be compensation-related. And if total compensation is competitive, it would be unlikely that significantly higher compensation would be offered elsewhere for his set of talents.

If retirement benefits, other benefits (which were not reviewed but are presumed to be reasonable and competitive), and the structure of the incentive plans are reasonable, then the critical issue for the competitiveness of total compensation is the competitiveness of the base salary. The remainder of my report will focus on this issue.

There are two issues related to the appropriate determination of a competitive salary: (1) the determination of the appropriate comparison (peer) group; and (2) the proper collection and analysis of data from that group to appropriately determine the competitive salary range for the position. Where there is a need for targets for total cash compensation (salary plus short-term incentive) and for total direct compensation (salary plus short-term incentive plus long-term incentive), as is the case in this situation, competitive ranges need to be determined for these as well.

a. The appropriate comparison group: Regarding the first issue, an appropriate peer group should include similar positions in similar industries and in organizations of similar size. This match is critical. Organization size and industry are the key variables influencing executive compensation. Executive pay increases significantly, but unevenly, as organization size increases. It is also important to note that while some executives can and do move across companies of different sizes, stratification tends to develop because skills and abilities developed at one size may not be fully transferable to a company that is larger or smaller. Executives in smaller companies tend to move to similarly sized companies, while executives in larger companies tend to stay in larger companies. This will especially be the case if they are trying to stay in a certain income range. So in a very real sense, the CEO of a $4 billion Blue Cross organization has a very different job than the CEO of a $500 million Blue Cross organization. Considering them peers is not appropriate for this work.

Mercer, the consulting firm advising BCBSVT on executive compensation during the period I reviewed, suggests that the standard peer group is from companies in similar industries that have between 50% and 200% of the revenues of the executive's company whose compensation is being reviewed. This is a very good standard. One problem that I will describe below, however, is that Mercer did not follow this guideline.

If the 50% - 200% standard guides the size of the companies used in the peer group, the remaining question is what groups of companies should be included in this analysis. Specifically, this is the question for BCBSVT during this period: Is the appropriate peer group a cohort that includes only CEOs from other BCBS organizations of similar size, or does the appropriate peer group include CEOs from non-BCBS managed care organizations of similar size as well?

As an aside here, it should be noted that Mercer presents data in its annual reports to BCBSVT from many other organizations that vary widely in size and industry. I would be very concerned if any of these organizations had been used as any portion of a peer group for the BCBSVT CEO position because they are simply not relevant. It is clear from a careful review of the reports, however, that all of this information was added to the report as additional information. There is no evidence that it was used in any way in the determination of the competitive range.

In the reports I reviewed, the only data that appears to have been considered relevant to the determination of the competitive range for this position is data from other BCBS organizations and data from a sample of non-BCBS managed care organizations. Data from both groups is included separately in several Mercer reports to BCBSVT for 2006 and 2007.

Mercer appears to have been somewhat confused about how the CEO's peer group was defined. Mercer made the following statement in the "Executive Summary of Findings" section of its April 2007 report:

> Generally, the President & CEO's base salary is targeted at the 25th percentile of the Blue Cross Blue Shield market and total direct compensation is targeted at the 50th percentile (also known as the median or middle) of the composite market. (p. 17)

In a discussion draft of its annual executive compensation review that was presented by Mercer in February 2008, this definition of the appropriate peer group is mentioned:

> The *primary reference* uses companies that are similarly-sized managed care and Blue Cross Blue Shield organizations. (emphasis theirs) (p. 7)

In the Appendix of that same report, Mercer describes its understanding of the peer group as "a market composite that consists of both BCBS and Managed Care market data." It states that from 2003 to 2007, the composite was based on 50% BCBS market data and 50% Managed Care market data. (p. 24) However, in the reports I have reviewed, there was no composite salary range information presented in 2005, 2006, or 2007. (I did not review any 2003 or 2004 reports.)

Whether just the BCBS group is recognized as the peer group or whether the peer group is defined as a composite group of BCBS and non-BCBS organizations makes an enormous difference. For instance, in the *Executive Compensation Review 2007* report, Mercer stated that the 25th percentile for the BCBS peer group was $503,000 and the 25th percentile of the managed care peer group was $346,000. The average of these two figures is $424,500.

Whatever Mercer's understanding of the appropriate peer group was, it is clear that the Executive Committee and Board gave preeminence to the BCBS-only group numbers in establishing Mr. Milnes' compensation. In December 2005, for instance, a Mercer report listed the 25th percentile for base salary of the BCBS group as $513,000, a managed care non-BCBS group as $341,000, and an insurance group as $298,400. At the time, Mr. Milnes' salary was $425,000. (*BlueCross BlueShield Vermont CEO Compensation Report, December 2005*, p.3) Based on that comparison, Mr. Milnes' salary was increased to $475,000 for 2006.

In March 2007, the following language in the Executive Committee's report to the Board (*CEO Compensation, Report of the Executive Committee*, March 2007) made this understanding of the appropriate peer group explicit:

> Based on a national comparison by Mercer Consulting of companies of similar industry and size, and in particular the Blues group, the Committee is recommending a base salary for 2007 of $500,000 compared to last year's $475,000. This amount would bring Bill for the first time to the 25th percentile of comparable companies. (slide 14)

Just prior to the creation of that recommendation, Mercer's report from the same month (*Executive Compensation Review, President & CEO Report, March 7, 2007*) lists three peer groups. The "Blues Only" peer group has a 25th percentile of $503,000. The "Managed Care" peer group has a 25th percentile of $346,000, and a "Northeast Managed Care and Health Organizations" peer group has a 25th percentile of $300,000. (p. 12) While the statement made by the Executive Committee references the Mercer study of comparable companies, the reference in the recommendation adopts the higher salary figures from the "Blues Only" peer group rather than using the average from any kind of composite group.

This is a very important point so I want to be very clear about what I observed in the Mercer and Executive Committee reports that I reviewed. With the exception of the February 2008 report, I did not see any evidence in the reports I reviewed to suggest that data from a composite group had ever been presented to BCBSVT. Data from non-BCBS managed care groups was presented separately. I also did not see any evidence in the reports I reviewed to suggest that data from either those non-BCBS managed care groups or a composite group ever influenced any decisions made about Mr. Milnes' compensation between 2005 and 2007.

The difference between Mercer's statement of the appropriate peer group for BCBSVT and the Executive Committee's reliance on "Blues-only" data for their decisions is not explained. It is important here to simply note the impact of that decision. Year after year, there is a huge difference between the pay of CEOs in the groups of BCBS-only and non-BCBS managed care organizations that Mercer reported. The 25th percentile of the salary range of the BCBS-only group was 50% higher than the 25th percentile of the non-BCBS managed care group in 2006

and 45% higher in 2007, the two years I reviewed. If the peer group had been considered a composite group (a combination of the two groups), and salary decisions were made based on the composite group date, the trajectory of Mr. Milnes' salary would have been very different, probably at least 25% lower than what it was.

I did not see any materials supporting this decision to use the BCBS-only group as the appropriate peer group. As stated previously, the question is about what positions are really comparable. That question is answered in practice by looking at recruiting patterns. Do BCBS executives move only among BCBS organizations, or do BCBS and non-BCBS have similar recruiting pools? Do they hire from each other? Information provided by BCBSVT makes clear that BCBS and non-BCBS organizations do hire from each other.

It is unclear why the salary ranges of the two groups would be so different. Mercer simply states that fact without elaboration in the *BlueCross BlueShield Vermont CEO Compensation Report, December 2005* (p. 3). I have not been able to find an explanation for the difference.

There is a related question as well. Mercer does not explain why the salaries of the BCBS peer group (measured at the 25th percentile) were increasing at an average of 10% per year during the 2001-2006 period when executive pay in general rose 5-6% per year in the same timeframe. (See p. 16 of Mercer's *Executive Committee, February 1, 2006* report for the BCBS peer group data. The 5-6% figure is based on my knowledge of national salary increase levels at that time.) From the limited data available in the Mercer reports, it does not appear that the salaries for the non-BCBS managed care organizations rose that rapidly either.

Before closing this section, it is interesting to note that when Deloitte Consulting reviewed the data in September 2007, it compared the BCBSVT executive pay structure and level against a

> customized benchmark that we developed using market pay data from appropriate peer organizations. These peer organizations consisted of for-profit and not-for-profit organizations with approximately $900 million in revenue and approximately 400 employees. Because BCBSVT recruits from and has lost employees to for-profit and not-for-profit organizations, it was appropriate to include both types of companies in this analysis. (p. II-68)

Deloitte does not identify the organizations in its sample. Since there are both for-profit and not-for-profit BCBS organizations in the US, if is not clear whether they included any non-BCBS in their benchmark (peer) group.

b. The proper collection and analysis of data: Separate from the question of the appropriate peer group, I also have concerns about the composition of Mercer's BCBS-only peer group. A chart in the *Executive Committee, February 1, 2006* report (p. 16) shows that the sample size for that group was just 6-8 BCBS groups for each year between 2001 and 2006. Some of these were much larger than BCBSVT. This sample increased to 15 in 2007 with the addition of data from

some BCBS organizations that were even larger. While Mercer tried to adjust the numbers to ensure that the result was really comparable to organizations the size of BCBSVT, I have never seen a formula that could do that accurately. As a result, I think the potential is great that the BCBS-only group data represented a salary range that was actually much higher than the true competitive range for the position.

The October 2007 Hewitt study independently used data from 13 BCBS organizations with revenues much more comparable to those of BCBSVT. (The range in the sample was 61% to 254% of BCBSVT's revenues.) Comparing the numbers from the Mercer and Hewitt samples for the same year shows a very similar 25th percentile, but the 50th percentile and the size of the ranges are very different. This should have raised questions about the Mercer samples. Because the Hewitt report was the last report available to me, I do not know if those differences in numbers were noted. The following chart compares the Mercer and Hewitt findings. (Only the 25th and 50th percentiles are listed because those were the only range data points reported by Hewitt.) Neither of the studies considered long-term incentives.

Blues Only Peer Groups	Salary $000)		Total Cash Compensation ($000)	
Survey	25th	50th	25th	50th
Mercer , March 2007	503	595	696	913
Hewitt , October 2007	494.6	538.2	711.3	764.6

The use of Hewitt's numbers would obviously make a significant difference in incentive targets. Again, I do not know if these differences were later addressed. However the peer group is defined, it should be obvious that a larger sample that has similar revenues to BCBSVT's will provide more accurate ranges. As I mentioned previously, Mercer suggested that a range of 50% to 200% of the size of BCBSVT should be used for a peer group, and I agree. Only 1 of the 13 data points in the Hewitt study was outside this range, which makes it a much more trustworthy source than the Mercer data for determining an appropriate "Blues-only" peer comparison.

* * *

I hope this analysis is useful in your deliberations.

Sincerely,

Frank Sadowski

Frank Sadowski
Partner

Exhibit C

Rate Adjustment Methodology

The rate adjustment methodology referenced in Paragraph B of the attached Order shall be as described herein. The aggregate amount of the rate adjustments will be $3 million and the initial adjustment will apply to all rates (for renewals and new business) with effective dates in 2011 except for any new ASO cases issued after 6/1/2010[1].

For this discussion we use $X to indicate the aggregate amount of rate reductions to be applied in the rating year under consideration. For calendar year 2011, $X will be $3,000,000.

The procedure for making the $X refund would be as follows:

- The adjustments would be made to rates with effective dates in four quarters (one complete rating cycle).
- A PMPM rate, R, equal to $X/(local[2] members as of the end of the previous month[3] * 12) will be determined. For rates effective in 2011 R=$1.88 PMPM[4].
- In the determination of the rates, by either actuarial or underwriting staff, the credit would be applied to the rates after determination in the usual manner.

This procedure will adjust the rates charged for case (policy) years beginning in 2011. At the end of 2012,[5] the total number of member months affected by these adjustments will be determined and multiplied by the amount R used to adjust the rates. If this result, A, is less than $3,000,000 then the process will be repeated setting $X to ($3,000,000 – A) and adjusting rates effective Q3 2013 through Q2 2014 (a second rating cycle).

If at the end of any quarter the RBC level of BCBSVT falls below 500% of ACL[6], this procedure will be suspended for subsequent quarterly ratings to which it would have applied. Once the RBC level of BCBSVT exceeds 500% of ACL at the end of a calendar year, the procedure will be reinstated and applied to the next quarterly ratings corresponding to each previous quarterly rating for which the process was suspended.

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[1] ASO cases are typically very large and application of this adjustment to a new ASO case would probably result in an amount returned significantly different from that anticipated and would potentially be inequitable to existing subscribers.

[2] i.e. Large Group (including Cost Plus), Small Group, Nongroup, Safety Net, Catamount, Medicare Supplement and TVHP

[3] i.e. at the end of the month prior to the month in which the calculation of R is performed.

[4] This was determined as follows:

$X	$3,000,000
local members 4/30/2010	132,640
R	$1.88

[5] Policy years beginning in December, 2011 will not complete until November of 2012, so the impact on the full rating cycle cannot be determined until then.

[6] Authorized Control Level